The Folly of Fed Interest Rates

The Federal Reserve, acting through its rate-setting Federal Open Market Committee, announced Tuesday that it would leave interest rates unchanged. The financial press dutifully reported this latest development, never questioning why, in a supposedly free, capitalist country, centralized economic planners set interest rates at all.

The problem for Mr. Greenspan and company is that the Fed simply has run out of room to cut rates. The federal funds rate already stands at 1%, a 46-year low. Greenspan has cut interest rates 13 times just since 2000, but Wall Street's thirst for cheap money cannot be satisfied. However, the markets have not responded. The trend that developed steadily throughout the 1990's, with the Fed cutting rates each time the economy showed signs of a downturn, has run its course.

The Japanese economy provides a vivid example of the futility of manipulating interest rates. Japan's central bank began cutting rates more than a decade ago, but the country remains mired in a stagnant economy. Ultimately, interest rates were cut to zero, where they have remained for several years. This rate cutting has failed to stimulate the economy, however. The Nikkei stock market index remains at 1980s levels, while Japanese unemployment recently exceeded 5%, the highest rate in decades. The Japanese experience should tell us that prosperity cannot be created out of thin air by a central bank.

In a truly free economy, interest rates are determined by market forces rather than central economic planners. The availability of investment capital, and the interest rate at which it is available, depends on savings, not fiat money and credit. The Fed's easy credit policies simply have made the cost of borrowing money artificially low. With lots of cheap money available, businesses and individuals spend with less discipline and incur more debt. Cheap credit created a wildly overvalued stock market, with many companies trading at outrageous prices. Eventually the bubble had to burst, resulting in record numbers of both personal and business bankruptcies.

The laws of supply and demand work better than any central bank bureaucrat in determining the correct cost of money, without the political favoritism and secrecy that characterize central banks. Americans should not tolerate the manipulation of our economy and the inflation of our currency by an unaccountable institution. The turbulent period we have entered may serve to remind Americans that the Fed cannot suspend the laws of economics. The key to lasting prosperity is a return to true private banking, where interest rates are set by the free market and dollars are backed by gold.